M&A – Tax Aspects

21 February 2015

Nitin Savara, Partner
Shuchi Gupta, Senior Manager
Modes of M&A

M&A

Acquisitions

- Business Transfer
  - Slump sale
    - Acquisition of business not of company owning the business
  - Itemized sale

- Share Purchase
  - Primary / Secondary
    - Focus on inorganic growth /strategic or non strategic investments

Merger / Demerger

- Amalgamation
- Demerger
  - Consolidation of businesses / entities through Court Scheme
  - Acquisition of specified business through Court Scheme
Merger
Merger concept: Illustration

- Company A to merge into Company B through a HC approved scheme of arrangement
- Pursuant to merger, all the assets and liabilities of Company A to be transferred to Company B
- Approval required from various stake-holders and regulators
- Company B to issue shares to the shareholders of Company A as consideration for merger
- Company A to dissolve without winding up pursuant to merger

The Circular from the MCA now requires RD to mandatorily refer the Scheme of Amalgamation / Demerger to income tax authorities
Cross border mergers

Merger of FCo A (holding IndCo) with FCo B

Shareholders

FCo A → Merger → FCo B

IndCo

Consideration in the form of shares of FCo B

Merger of FCo with IndCo

Shareholders

FCo → Merger → IndCo

Consideration in the form of shares of IndCo

Merger of IndCo with FCo – Outbound merger (Proposed in Companies Act, 2013 – Not notified)

Shareholders

IndCo

FCo

Consideration in the form of shares of FCo

Companies Act 2013*, permits this form of outbound merger (subject to fulfillment of prescribed conditions) which was previously not permitted under the Companies Act, 1956

Tax Implications could arise, unless there are certain amendments made to tax laws

*For training and discussion purposes only
Key tax considerations

Appointed Date concept
► Appointed date is the date from which the consolidation is effective, and financials are consolidated
  ▶ Can be prospective or retrospective
  ▶ Typically, decided in light of various administrative, accounting, tax and regulatory considerations

Specific capital gains exemption for:
► Transfer of a capital assets by Transferor to Transferee Indian company
► Transfer of shares by shareholders of Transferor in consideration of the allotment of shares in Transferee Indian company

Carry forward of tax losses
► Prescribed conditions for allowing carry forward for set off, losses and unabsorbed depreciation of Transferor to Transferee -
  ▶ Transferor to own an ‘industrial undertaking/ ship/ hotel/ bank/ aircraft
  ▶ Compliance with allied conditions
  ▶ Fresh lease of life of 8 years for the losses of the Transferor

Tax neutral merger
► Cumulative conditions for tax neutrality –
  ▶ All properties and liabilities of the transferor company are transferred to the transferee company
  ▶ At least 3/4th in value of shareholders of the amalgamating company (other than shares already held therein immediately before amalgamation by the amalgamated company or its subsidiary) should become shareholders of the amalgamated company;
### Key tax considerations

<table>
<thead>
<tr>
<th>For shares issued as consideration for merger</th>
<th>For capital assets transferred through merger</th>
</tr>
</thead>
<tbody>
<tr>
<td>► COA of shares in Transferee Co = Cost incurred for acquiring shares of Transferor Co</td>
<td>► COA of capital assets transferred to Transferee Co = Cost incurred by Transferor Co for acquiring such assets</td>
</tr>
<tr>
<td>► Period of holding of shares in Transferee Co to include period of holding of shares in Transferor Co</td>
<td>► Period of holding of capital assets transferred to Transferee Co to include holding period of Transferor Co</td>
</tr>
</tbody>
</table>

#### Tax depreciation claim

► Total depreciation for the year to be apportioned between Transferor and Transferee based on number of days of usage (Appointed Date)

#### Indirect Tax

► Not liable to sales tax/ VAT
► Indirect tax credits generally available with Transferee Co post merger

**Whether equity and preference shareholders should be issued equity and preference shares respectively on amalgamation?**

**Tax depreciation on goodwill created on merger – Supreme Court Ruling**
Demerger concept

Overview

- Demerger involves transfer of identified undertaking from Demerged Company to Resultant Company.
- In consideration, Resulting Company issues shares to shareholders of Demerged Company.
- Demerger is a High Court driven process.

No shares to be issued by R Co as it holds 100% shares of D Co.

Demerger of DIV 2

Post demerger

X% - depending on swap ratio

For training and discussion purposes only
Why demerge – Some commercial reasons

- Unlocking business value
- Segregation of core and non-core business
- Creating different verticals – based on business/ risk profiles
- Ease in future capital raising for specific business
- A step towards divestment – partial or full exit
- Other commercial/ business reasons
Key tax considerations

Tax neutral demerger conditions

► **An undertaking is to be demerged**
  ▶ What constitutes as “undertaking”
  ▶ Should Demerged Co have more than one undertaking, pre-demerger

► All properties and liabilities relating to the undertaking required to be transferred

► Transfer of assets and liabilities at book value
  ▶ Liabilities to include - all specific and allocable general/ multipurpose borrowings

► Consideration to shareholders of Demerged company by way of issue of shares in Resulting company on a proportionate basis

► Shareholders holding at least 75 % in value in Transferor to become shareholders of Resultant company

► Transfer effected on a going-concern basis

Specific capital gains exemption for:

► Transfer of a capital asset by Demerged company to Resulting Indian company

► Issue of shares by Resulting company to shareholders of Demerged company

No dividend tax on release of assets

Carry forward of losses

► Quantum of losses of Transferor to be transferred to Transferee
  ▶ Losses directly relatable to the transferred undertaking
  ▶ Losses not directly relatable to the transferred undertaking – to be apportioned in the ratio of, the assets transferred to Transferee to total assets of the Transferor prior to demerger

► No fresh lease of life for tax losses
Key tax considerations

Demerger expenses
► Expenditure allowed as deduction for tax purposes - 1/5th of such expenditure to be allowed as deduction for 5 consecutive years

Tax depreciation
► Tax WDV of assets of demerged undertaking (those eligible for tax depreciation) to remain same for Resultant company

Tax WDV of assets for demerged company
► WDV of residual assets in the hands of Demerged Co = Total WDV of assets before demerger less WDV of assets transferred

For shares issued as demerger consideration
► Proportionate cost of acquisition available to the shareholders in the Resulting Company and the Demerged Company
► Period of holding of shares in Resulting Co to include period for which shares were held in Demerged company

Sales tax/ VAT
► Similar to the case of Merger

For training and discussion purposes only
Case Studies

Source: Based on information available in public domain
Case Study 1 - Polaris – Value unlocking

Background
► Polaris is engaged in IT Services and Products

Objective
► Separation of IT Products business into a separate listed company
► Offer an exit to public shareholders from products business

Salient features of demerger scheme
► Demerger of IT Products business into Intellect Design
► Exit option to public shareholders from Intellect
► Option to public for exchange of Intellect Equity Shares into 7.75% secured NCDs of Rs 42 each, tenure of 90 days
► Intellect public shareholding not to fall below 25%, due to NCDs
Case Study 2 - Wipro – Business structuring

Background
► Wipro Limited (WL) is engaged in IT business and non IT business

Objective
► Separation of non IT business into an unlisted company
► Ensure compliance with minimum public shareholding requirements of 25% under Rule 19(2)(b) of SCRR in Wipro
► Diversified business housed in unlisted co, and allow respective business to grow independently while benefiting from sharing of the Wipro brand

Salient features of demerger scheme
► Demerger of non IT business into WEL
► WEL to be an unlisted company
► Exit options given discussed in subsequent slides
## Case Study 2 - Wipro – Business structuring

### Salient Features

<table>
<thead>
<tr>
<th>Resident shareholders (either of the following three)</th>
<th></th>
</tr>
</thead>
</table>
| 1 – Allotment of RPS | ▶ Receive one 7% RPS in WEL (face value – Rs 50), for every five equity shares of WL  
  ▶ Maturity period – 12 months and redeemable at Rs 235.20 |
| 2 – Allotment of equity | ▶ Receive 1 equity shares (Face Value – Rs 10) of WEL for every 5 shares (face value – Rs 2) in WL |
| 3 – Equity swap (Default option) | ▶ Exchange equity shares of WEL for WL shares, swap ratio being 1 share for every 1.65 equity shares in WEL |

<table>
<thead>
<tr>
<th>Non resident shareholders (except ADR holders) (either of the following two)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1 – Allotment of equity</td>
<td>▶ Receive 1 equity shares (Face Value – Rs 10) of WEL for every 5 shares (face value – Rs 2) in WL</td>
</tr>
<tr>
<td>2 – Equity swap (Default option)</td>
<td>▶ Exchange equity shares of WEL for WL shares, swap ratio being 1 share for every 1.65 equity shares in WEL</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ADR holders</th>
<th></th>
</tr>
</thead>
</table>
| Allotment of equity and compulsory swap | ▶ Receive 1 equity shares (Face Value – Rs 10) of WEL for every 5 shares (face value – Rs 2) in WL; and  
  ▶ Exchange equity shares of WEL for WL shares, swap ratio being 1 share for every 1.65 equity shares in WEL |
What is Business acquisition?

- Acquisition of:
  - all or some of the assets and liabilities
  - of a business
  - for a considerations
  - in cash and/or in kind

- The consideration may be allocated to individual assets and liabilities or could be a lump sum consideration for the assets and liabilities

- Business acquisition may be done in following manner:
  - Share purchase
    - Primary infusion
    - Secondary acquisition
  - Business transfer
    - Slump sale
    - Itemized sale
Share acquisition

Secondary acquisition

- Transfer of shares by Existing Shareholder(s) of Target to Acquirer
- Acquirer to discharge consideration – Monetary/ non-monetary

Alternative – Infusion (Primary)

- Cash infusion in Target by acquirer for acquisition of stake
- No consideration received by the shareholders of Target
- More prevalent where funds required at the Target’s level and/ or acquisition of part stake by acquirer
### Key tax considerations

#### Direct tax

**Withholding tax implications on initial acquisition**
- No withholding tax on payment to residents for the purchase of shares
- If selling shareholder is a non-resident and such share sale is taxable in India, Acquirer to withhold appropriate tax on payment of consideration

**Capital gains on future sale/ exit**

**Cost of acquisition**
- Cost of acquisition is the actual price paid by the acquirer and includes all the expenses incurred by to acquire the shares viz. stamp duty, share transfer fee, legal cost etc.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Holding period for LTCG</th>
<th>LTCG rate</th>
<th>Holding period for STCG</th>
<th>STCG rate</th>
</tr>
</thead>
</table>
| Listed shares                        | More than equal to 12 months | ► Exempt if sold on SE  
► Off market sale 
  - 20% with indexation or 10% (no indexation) | Less than 12 months | ► 15% if sold on stock exchange  
► Off market sale - 30% |
| Shares of unlisted public company/ private company | More than equal to 36 months | 20% with indexation (for residents) | Less than 36 months | 30% |

*Notes - Tax rates are exclusive of surcharge and cess; Tax rates applicable to a resident seller*
Key tax considerations

**Direct tax**

**Implication on business loss / unabsorbed depreciation**
- IT Act provides for specific restriction on the carry forward and set off of accumulated business tax loss in case where is a change in the shareholding of a private company by more than 49%.
- No impact on unabsorbed depreciation pursuant to change in shareholding.

**No objection certificate from tax authorities for Section 281 (secondary tax risk)**
- NOC may be obtained from tax authorities to safeguard against secondary tax risk.

**Indirect tax**

**VAT**
- No VAT levied on transfer/ issue of shares.

**Indirect tax credits**
- No impact on Indirect tax credits of the Target company pursuant to transfer/ issue of shares.
Slump sale - Key tax considerations

Slump sale – Definition under the Income Tax Act, 1961

► Transfer of one or more ‘undertaking’ as a result of sale

► For a lump sum consideration
  ► Without assigning values to individual assets and liabilities

► However, value can be assigned for the purpose of payment of stamp duty, registration fees or other similar taxes or fees

► Taxable transaction
  ► Specific methodology prescribed for computing capital gains

Undertaking - meaning

► The term ‘Undertaking’ is defined under Explanation 1 to section 2(19AA)

► ‘Undertaking’ shall include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity
Slump sale - Key tax considerations

**Capital gains on slump sale**

- For determining the nature of capital gain, period of holding of undertaking will be taken into consideration (capital gain will be long term if undertaking is held for more than 36 months)
  - No indexation benefits available
- Cost of acquisition = Net worth of the undertaking
  - Net Worth is aggregate value of assets less the book value of liabilities
  - Aggregate value of assets is written down value (determined in accordance with the Income Tax Act, 1961) of depreciable assets and book value of other assets

**Carry forward of business losses and unabsorbed depreciation**

- Brought forward losses/ unabsorbed depreciation specific to the undertaking will not get transferred
# Itemised sale - Key tax considerations

<table>
<thead>
<tr>
<th>Capital gains</th>
<th>Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction non tax neutral</td>
<td>Sale proceeds of depreciable assets would reduce the block</td>
</tr>
<tr>
<td>Gains arising on sale of capital assets taxed as Long/ short term capital gains depending on period of holding</td>
<td>If the block ceases to exist, tax would be charged on additional consideration</td>
</tr>
<tr>
<td>Capital gains to be computed for each item of capital asset sold as per regular capital gains tax provisions</td>
<td></td>
</tr>
<tr>
<td>Long term capital gains if asset held for &gt; 3 years</td>
<td></td>
</tr>
<tr>
<td>Short term capital gains if asset held for up to 3 years</td>
<td></td>
</tr>
<tr>
<td>Provisions of Section 50 shall apply in the case of sale of depreciable assets that form a part of a block of assets</td>
<td></td>
</tr>
</tbody>
</table>

**Cost of acquisition in the hands of the buyer**

- Cost at which assets are acquired would be the cost of acquisition

**Indirect tax**

**Sales Tax/ VAT**

- Leviable on assets being transferred
- Depends on the state where the property is situated

**Indirect tax credits**

- Acquirer not entitled to tax credit remaining unutilized in the hands of the seller
Questions!